HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. ■ Ranking Democratic Member

214 O'Neill HOB ■ Washington, DC 20515 ■ 202-226-7200 ■ www.house.gov/budget_democrats

December 20, 2001

Republican Tax Cuts Mean Higher Long-Term Interest Rates

Dear Democratic Colleague,

The Federal Reserve has cut short-term interest rates by 4.75 percentage points in the last year, but long-term rates have fallen less than half a percentage point over the same period.

The long-term rates faced by businesses financing new investment and homebuyers taking new mortgages are staying high primarily because of Republicans' $1.7 trillion tax cut and their proposals for additional permanent tax cuts. The abrupt deterioration of the long-term fiscal outlook due to Republicans' tax cuts has signaled to the financial markets that government will be soaking up a substantial portion of new credit for years to come, forcing private-sector borrowers to pay more. By contrast, eight consecutive years of fiscal improvements during the Clinton Administration pushed long-term interest rates down to their lowest levels in almost thirty years.

The attached study by the Democratic staff of the House Budget Committee outlines the effects on financial markets of this year's reversal of fiscal discipline. I commend it to you and hope that you won't hesitate to call on me or the Budget Committee staff if you have any questions.

Sincerely,

John M. Spratt
Ranking Democrat

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Senator Schumer*: One other thing you mentioned that one of the reasons -- I think this was to Senator Reed -- that you thought that rates hadn't come down enough was that the rate of decline of Treasury debt had been not as great as we thought. Is that due to the economy, the slowing of the economy? Is that due to the tax cut?*

Federal Reserve Chairman Greenspan*: I think it's basically due to a series of things: one, the tax cut; two, expenditure increases which were higher than expected; and three, the economy.*

Senator Schumer*: Right, so the tax cut did have a negative effect on this?*

Chairman Greenspan*: Oh yes, no question.*

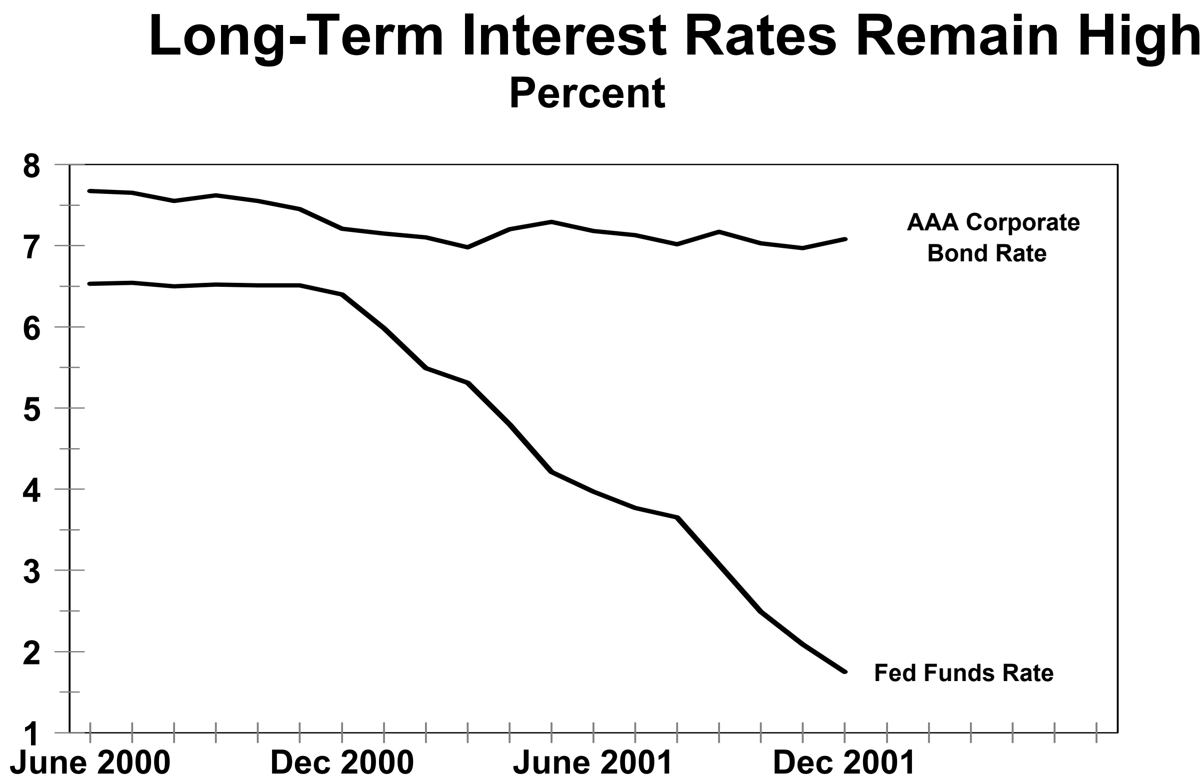
Senate Banking Committee hearing
July 24, 2001

The Federal Reserve has cut short-term interest rates by 4.75 percentage points in the last year, but long-term rates have fallen less than half a percentage point over the same period. Why have long-term rates remained stubbornly high? Most of the blame falls on Republicans' $1.7 trillion tax cut and their proposals for further permanent tax cuts, which are ballooning the deficit. By contrast, eight consecutive years of fiscal improvements during the Clinton Administration pushed long-term interest rates down to their lowest levels in almost thirty years.

The Federal Reserve responded promptly and aggressively to the economic slowdown. Last January, three months before the recession officially began, the Fed started lowering their target for the Fed Funds rate—the only interest rate that they directly control. With their most recent cut this month, they have reduced the Fed Funds target rate eleven times, for a total decline of 4.75 percentage points. The Fed Funds target now stands at a mere 1.75 percent.

The recent monetary easing has been the most aggressive anti-recession response in Fed history except for the devastating 1981-82 recession, when an already high unemployment rate was headed up over 10 percent.

However, the Fed's reduction of the Funds rate—the interest rate financial institutions charge one another for overnight loans of reserves—hasn't translated into a reduction of the long-term interest rates at which firms and home buyers borrow. The chart below shows the sharp drop in the Fed Funds rate since December and the essentially unchanged level of the AAA corporate bond rate.



The spread between the AAA bond rate and the Fed Funds rate—currently 5.3 percentage points—is the largest on record (data were first collected in 1954). The current spread between the Funds rate and mortgage rates is almost as large at 5.1 percentage points. At this point in the 1990-91 recession, the rates on AAA bonds and home mortgages had both declined about a half percentage point more than in the current downturn.

Unfortunately, the Fed's influence on economic activity is limited by the extent to which changes in short-term rates translate into changes in long-term rates. Businesses' investment decisions and households home-buying decisions depend on long-term financing. But, several factors other than Fed policy—interest rates abroad, perceptions of risk and inflation, and the impact of government borrowing on the financial markets—affect the interest charged on long-term loans.

It should be obvious—and, judging from his comments, it is obvious to the Chairman of the Federal Reserve—that the evaporation of $3.0 trillion in projected government surpluses in just a few months is having a major impact. The prospect of higher government demand for long-term credit in coming years is pushing up the cost of such credit.

Even in a world with global financial markets, $3 trillion is enough money to get people's attention, especially when the money disappears abruptly. Just six months ago, Republicans claimed that the $5.6 trillion surplus was so huge that Congress could pass an exploding tax cut, a Medicare prescription drug benefit, new resources for a modernized military, and substantially more education funding—and still have money left over. Even after enacting all these policies, Republicans argued, we'd still have to worry about paying off the public debt ***too fast***.

Now in just six months, the projected surplus has dropped to $2.6 trillion, as estimated by the House and Senate Budget Committees in October, with 55 percent of the deterioration attributable to the Bush tax cut. The $3 trillion decline in projected surpluses means that the government will retire $3 trillion less of its debt, leaving private borrowers competing for a smaller pool of financing than would otherwise be the case. This has put upward pressure on borrowing costs.

Recent comments by OMB Director Mitchell Daniels suggest that the long-term surplus may have fallen by more than the $3 trillion assumed by the Budget Committees. He foresees persistent deficits and increasing government borrowing over the next three years. This prompted an urgent Administration request to raise the statutory limit on the public debt, something that they had claimed only six months earlier wouldn't be necessary until 2009.

When CBO and OMB release their new budget forecasts early next year, the long-term projections may show that some of the deficits that Director Daniels predicts for the next several years can be recouped by running surpluses in 2005 and beyond. Unfortunately, financial markets are likely to perceive the threat of increasing government debt in the next few years as more credible than promises of a return to fiscal discipline in the distant future. In that event, the financial markets will have good reason to bid up long-term interest rates.

We saw in the last eight years what a credible commitment to fiscal discipline can do to hold down interest rates, promote investment, and create jobs. We are now seeing how financial markets react to the absence of such a credible commitment.